TOREVELL &PARTNERS

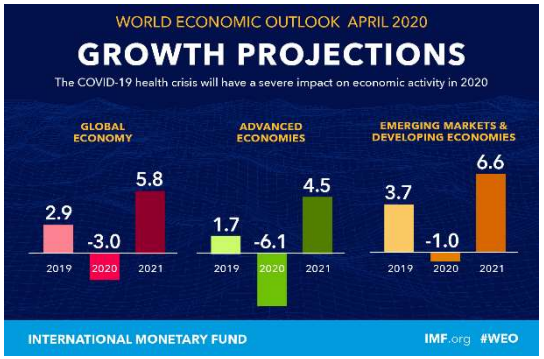
Economic Background – May 2020

Always asking questions[1]

As humanitarian cost of the Coronavirus continued to mount through April, the global lock down response from most countries has provided an economic shock not seen in modern times. We have all been impacted in this extremely challenging environment and whilst the Covid-19 data from western countries improves, the economic consequence is still being counted. There are still a number of questions that need to be answered.

Is this a dent in the road or a sinkhole for the global economy?

The impact of the pandemic has travelled globally over a number of months. It has transitioned from a Chinese supply/demand crisis to a global supply/demand crisis driven by those countries who have chosen to enforce lockdowns. Global gross domestic product (GDP) fell in the first quarter of the year and is expected to decline over the next two quarters. The International Monetary Fund's base case is that the global economy will contract by 3% in 2020 (worse than the 2008-09 financial crisis) and that if the pandemic fades in the second half of the year and containment efforts are lifted then with the global economy should grow by 5.8% in 2021, helped by global policy support.



However the timing and containment measures of each country are very different. This suggests a volatile recovery, with real risks of setbacks and breakthroughs at differing times. Should a second wave of epidemic or further containment measures be put in place, economies will be further hampered on their road to recovery.

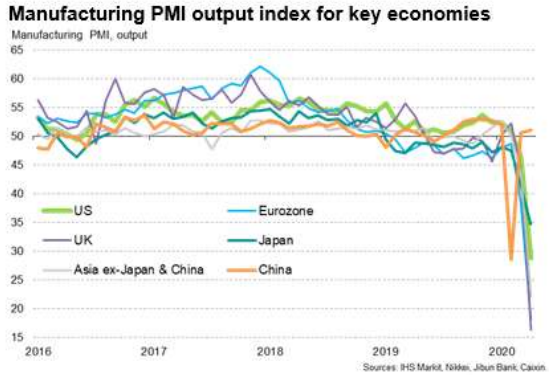
Forecasting is difficult in these volatile times. Initial estimates of US GDP growth for the first 3 months of the year was -4.8% compared to forecasts of -3.5%, with economists expecting the decline to increase when the final version is completed. Consumer expenditure declined 7.6% in the quarter, with durable goods falling 16.1% and services 10.2%. This is during a quarter in which the economy was functioning normally during January and February. The second quarter of the year is expected to be far worse, with economists forecasting a c40% fall in US GDP. The European Commission expects the Eurozone GDP to shrink by 7.7 percent this year, before rebounding by 6.3 percent in 2021, saying the economy will experience a recession of historic proportions due to the coronavirus pandemic. The latest to release their estimates is the Bank of England (BoE) who predict that UK GDP will fall 3% in the first quarter followed by 30% in the second quarter.

It is clear from the data released that there is going to be a significant deterioration of GDP over the next few months and quarters. The global service and manufacturing PMI (Purchasing Managers Index) data is in severe contraction.

"The PMI has signalled three successive months of deteriorating health of worldwide manufacturing, with April seeing a marked intensification of the decline amid the escalating COVID-19 pandemic.

The declines pushed both the global output and new orders indices down to their lowest since January 2009. The survey's output index is historically consistent with global production falling at an annual rate in excess of 15%, though experience from the global financial crisis suggest that the actual decline could even be somewhat steeper than that indicated by the survey index."

IHS Markit



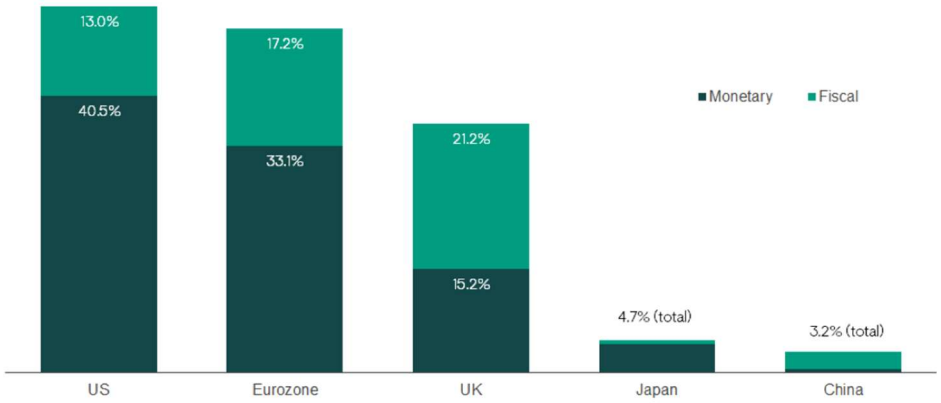
[1] Howard Jones, 1983.

China's easing of lockdown conditions has boosted its PMI, but growth is still weak (PMI needs to rise well above 50 to indicate robust growth). However it does indicate that when the lockdown measures across the world are relaxed some recovery can be achieved.

What shape and how fast will the recovery be?

The scale, speed and targeted nature of the monetary and fiscal measures taken are unprecedented. Central banks have acted to ensure the financial system is well lubricated with liquidity and governments have tried to provide support to the worst affected employees and businesses. The US Federal Reserve has cut rates to zero, cutting by a cumulative 150 bp, while promising unlimited QE. The European Central Bank have launched a pandemic emergency purchase program of €750bn to buy bonds and other assets alongside giving banks €3tn of cheap liquidity and €120bn in capital relief. The Bank of England at their recent meeting kept interest rates at 0.1% and are maintaining their bond buying at £645bn, although 2 members of the committee wanted to increase it by £100bn.

Key Stimulus measures to date (% of GDP



Source: Ninety One Asset Management

However the levels of government support cannot last forever. We have witnessed in the US and Europe a rise in unemployment and once the furlough period is over, we would expect this to occur in the UK too. In the US, the surge in jobless claims since the first lockdown measures has been unprecedented, and in a few weeks wiped out all jobs created in the past decade of economic expansion. In the week ending 2 May a further 3.2 million people filed for unemployment benefits bring the total to 33.5 million in the last 2 months. Economists believe the unemployment rate currently is greater than 20%, which is close to the peak rate in the Great Depression of the 1930's.

In the UK and EU, many governments have followed Germany's lead from the financial crisis, with governments offering to pay employees' salaries (up to a level) providing businesses agree to avoid making them unemployed. These furlough schemes are time limited, but do allow companies some breathing space during the worst of the crisis to pass (providing there is no re-emergence of the virus) in their respective countries. The BoE said it believes the UK unemployment rate will to rise to 9% despite the current furlough scheme. If this came to pass it would mean a higher unemployment rate than after the financial crisis in 2008/2009.

A rapid recovery may well be hampered by unemployment and the possible effects on employment once furlough measures are lifted. Even if employment comes back quickly, the psychological implications on disposable income, spending and saving patterns in both the short and longer term will be altered significantly. The same argument can be applied to businesses and their capital expenditure programs, which are likely to affect imports/export dynamics and global trade overall. When weighted against the ongoing trade disputes of the US-China and the UK-EU, then the ability to forecast what the path of the economy and trade will be in 12 months' time with any degree of accuracy is extremely unlikely.

What will earnings, dividends and valuations look like?

Despite the barrage of poor economic data, stock markets have recovered some or most of what they lost during March. The US stock market has recovered best and in particular the technology sector. April was one of the best monthly returns on record in the US. As I write in May the Nasdaq is positive for the year, which is incredible. There is a widely held feeling that the stock market and economy have disconnected, perhaps buoyed by the announcements >$2 trillion of monetary and fiscal stimulus and an apparent improving virus outlook. The US technology, communications and health care sectors which represent over 40% of the US market are seen as structural 'winners' of the crisis. The FAAMGs (Facebook, Amazon, Apple, Microsoft and Google) make up 20% of S&P 500 and have been the principal drivers of US stock market returns.

As a portfolio they are up 10% in 2020 with the other 495 stocks in the S&P500 are down -13%. Amazon and Google (Alphabet) operate as near monopolies – and are under increased risk of regulatory or political interference along with Facebook. Microsoft and Apple both have leading positions in their sectors and have attractive products, but at some point valuation must form part of the decision making process for investors. All these companies trade at high forward earnings and sales estimates. Given that the future is uncertain and the data in Q2 is increasingly looking bleak, we believe it is prudent to remain underweight to the "priced to perfection" momentum driven "Big 5". The global lockdown has brought forward a number of existing technological trends. The CEO of Microsoft Satya Nadella commentated that he had seen

	Total return		2019-21E CAGR		Price/ 2021E	EV/ 2021E
Ticker	2019	YTD	Sales	EPS	EPS	Sales
MSFT	58 %	14 %	12%	13%	27x	8x
AAPL	89	0	3	6	22	5
AMZN	23	34	22	36	58	3
GOOGL	28	1	15	9	21	3
FB	57	(0)	17	17	23	5
Top 5	**54 %**	**10 %**	**14%**	**12%**	**28x**	**4x**
Other 495	28	(13)	1	2	16	2
S&P 500	**31 %**	**(9)%**	**2%**	**2%**	**17x**	**2x**

Source: FactSet, Goldman Sachs Global Investment Research

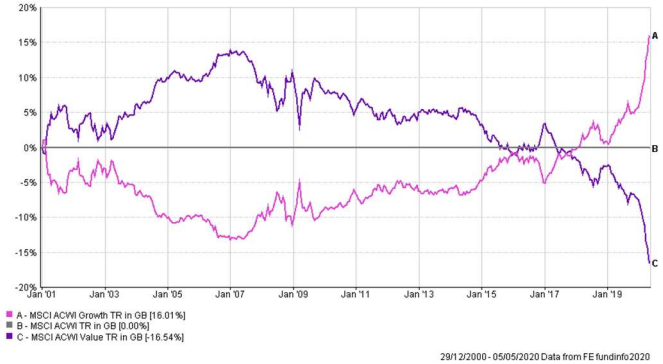
"two years' worth of digital transformation in two months"

However consumer and business focussed technological companies will not be immune to the recession. Fewer adverts will be published, purchasing the latest gadget will not be high up on agendas, businesses will try to conserve cash and not spend as much on capital expenditure software projects. Longer term we may recognise that we have experienced an acceleration of the trend to digitisation. For us to fully embrace the new way of working we would like to see some evidence first that this will remain the case post lockdown.

With the final companies in the S&P500 yet to report their first quarter earnings the expectation is of an earnings decline of around 10%. More significantly, according to the data aggregated by Factset analysts expect earnings to decline by 28% in the second quarter. However much will depend upon the timing and scale of the lifting of lockdown measures. Many companies are unable or unwilling to provide guidance for the rest of the year due to the ongoing crisis, and we expect a great deal of earnings and market volatility moving forward. Despite the rise in markets over the last six weeks the VIX volatility index remains above 30, indicating traders expect higher than normal market movements.

Over the past number of years stock market prices in the US performed better than the underlying earnings. History tells us that eventually this relationship will converge, if earnings or cash flows determine market values. So either earnings will increase (unlikely in this environment) or prices will fall. The cyclically adjusted price to earnings (CAPE*) ratio of the US is greater than 26x, with a price to book of 3x. It's expensive. That doesn't mean it can't remain expensive or that it can't keep on becoming more expensive. What it does suggest is that the probability of return for the US market over the coming years is less than a less expensive market. The UK CAPE for example trades at 12.5x and a price to book of 1.4x.

Value remains unloved. The chart below shows the performance of "growth" stocks (in purple) and "value" stocks relative to the MSCI All countries world index over the last 20 years. Value stocks outperformed in the aftermath of the technology bubble until the Great Financial Crisis and the advent of large scale quantitative easing. Since then growth (fuelled by ultra-low interest rates) has driven the disparity between Value and Growth to record levels.



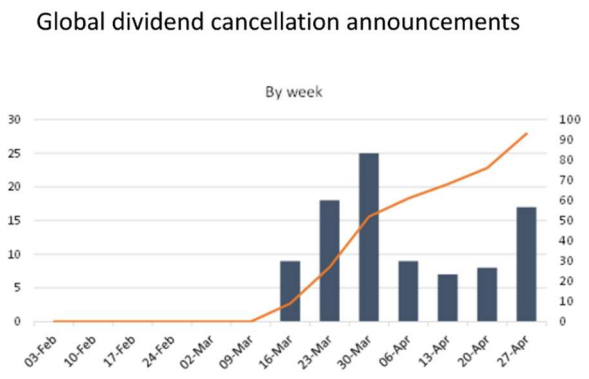
Today, the valuation dispersion between Value and Growth is greater than at the start of the tech bubble collapse. We would expect this valuation disparity to revert to the mean over time, but in the short term the increasing focus on growth at any price has hurt the performance of funds which emphasise investing in undervalued stocks.

An element of the recent acceleration of disparity between Value and Growth has been the focus on companies' dividends. Dividends continue to be reviewed by boards of companies,

TOREVELL &PARTNERS

with the following common themes of pausing or cancelling dividends - the sudden halt to the economy leading to a cash crunch; prudence; and regulatory or government pressure.

In the UK 45% of companies have cancelled dividends in April and the expectation is that we are likely to see a 30%-40% cut in dividends during 2020. We continue to believe that our stable of managers will provide a better outcome than that of the market. In general, we have a low exposure to Banks, Housebuilders, Miners, Leisure and Hospitality businesses. The oil price has been extremely volatile over the past month causing Royal Dutch Shell to cut its dividend by 66%. Our fund managers focus on the financial strength of a company, the balance sheet and cash flow, as this is how you avoid permanent loss of capital.



Source: Guinness Asset Management

Recent announcements have seen the US Federal Reserve and the European Central Bank purchase and support debt and credit markets. Central Banks's support for credit markets is a positive tailwind for sentiment and has allowed for the normal functioning of the investment grade market to return. Corporate issuance in April has been the largest on record, with companies offering good premiums for investors. Boeing's $25bn deal, which is the 6th largest issue on record was offered with yields of 5.15%, 4.50% more than the equivalent US government bond yield with equivalent duration. We started the year with credit markets offering low yields and very narrow spreads, with unattractive valuations, although the panic in March recalibrated a number of fixed income opportunities. High yield markets are pricing in a 10% default rate with risk free rates remain incredibly/artificially low and are likely to be for the foreseeable future.

Chris Davis,
Chief Investment Officer

*CAPE (Cyclically adjusted price to earnings ratio) is a valuation measure that attempts to smooth out the business cycle on earnings. It is calculated by dividing the share price by the inflation adjusted average of 10 year earnings per share.